

STATEMENT OF MARTIN FELDMAN

SALOMON SMITH BARNEY

**BEFORE THE
SENATE COMMERCE COMMITTEE**

March 19, 1998

Chairman McCain, Senator Hollings, and other Members of the Senate Commerce Committee, thank you for the opportunity to present my views on the proposed legislated tobacco settlement. I am an equity analyst at Salomon Smith Barney with responsibility for research coverage of the tobacco sector. The primary role of an analyst is to research all those elements that influence the market valuation of securities and to advise investors accordingly. My only objective is to forecast accurately the fortunes of tobacco equities; I neither support nor oppose either side in this debate. While in most market sectors, earnings fundamentals are the most significant aspect of valuations, tobacco equities are valued largely on the basis of investor's perceptions of external and public policy factors—the most important of these being the litigation challenges facing the industry, as well as prospects for the Proposed Resolution currently being considered by this Committee.

Since initiating research coverage of the tobacco sector, I have sought to specialize in the international tobacco markets, and believe that the foreign markets may provide critical points of reference for your consideration of the Proposed Resolution. The Committee has been provided with my analysis of the Proposed Resolution and its likely impact on US cigarette pricing and consumption. In short, I believe that it complies with President Clinton's stated desire for retail cigarette prices to increase by "up to \$1.50" within ten years.

Before addressing the important issue of US tobacco pricing policy, I would like to

highlight a few precedents from the foreign markets that may be instructive:

1) The most significant impact of a tobacco policy that relies **only** on sharply rising prices is a severe reduction in national cigarette volumes. It is this sharp reduction that will likely impart most pain on the US tobacco industry. A recent First World example is the Swedish experience. In order to accord tobacco excise tax policies for its membership to the European Union, the real retail price of cigarettes in Sweden rose by 43.4% between 1992 and 1996. National volumes fell 23% during this period, and a price elasticity of demand of 0.67 was experienced. There is strong evidence to suggest that the steeper the price increase, the greater is the decline in adult consumption. If the McCain bill was legislated in the US during 1998, we believe that a similar 41% real price increase would be achieved by 2000.

2) Between 1988 and 1996 the real price of 20 cigarettes in the UK rose by 26% while national cigarette volumes fell 17%. This decrease did not reflect amongst teenagers. The Office for National Statistics defines a youth smoker as one who usually smokes ***“at least one cigarette a week.”*** On that basis, the percentage of smokers amongst those aged 11 to 16 increased from 8% in 1988 to 13% in 1996, despite the hefty real increase in price. I am more optimistic for the effectiveness of the Proposed Resolution in the US. This is largely as a result of the non-financial aspects of that proposal. These include severe access restrictions, sizable sums for anti-smoking advertising, research into smoking behavior, and incentives to the individual states to help reduce the incidence of youth tobacco consumption.

2) There is an important difference between per capita consumption, and the rates of smoking incidence in any national market. The approximate average price of cigarettes in the US was \$1.75 during 1996, while per capita consumption was almost 2,000 cigarettes and the national smoking incidence was 26.4%. Compare that to the UK where the price was \$4.40, yet the incidence and per capita consumption were 27% and 1,392 cigarettes, respectively. In Norway cigarettes were priced at \$6.82 in 1996, yet during that year, smoking incidence was a high 38%, while the per capita consumption was just 610 cigarettes. I believe that these examples are instructive of the fact that higher retail prices lead to falling per capita consumption, but not necessarily to a similar influence on smoking incidence. Within the US context, it may be the non-financial aspects that—perhaps uniquely—may promote parallel reductions in both incidence and consumption.

2) Another point of importance is the often down-played significance of contraband tobacco volumes. There are many pertinent illustrations of the speedy and efficient growth in black market cigarette volumes. Some of the most serious include: 1) US cigarettes into Canada; 2) Polish product into Germany; 3) Turkish cigarettes into Kazakhstan; 4) Round tripping of South African cigarette volumes, and 5) (A particularly striking example,) About 75% of the UK handrolling tobacco market consists of volumes

that have been legally exported to Belgium and Luxembourg, and then illegally shipped back to the UK. This procedure endures despite well-policed borders and regular initiatives by the authorities in an attempt to curb this practice.

I would now like to turn briefly to the US pricing and consumption model I have provided. It is my contention that if the S.1414 proposed bill was legislated in the middle of this year, then by year five, or 2003, retail cigarette prices may have grown by 91% in nominal terms, or by 71% in real terms (from \$1.82 in 1997). National cigarette volumes will likely have fallen between 16% and 22%, while teen consumption may have decreased by a minimum of 30% from estimated 1997 levels. By year ten, or 2008, retail cigarette prices may have grown by \$2.42, or 133% to \$4.24 in nominal terms. In real terms, prices might have increased by \$1.63, or 89% to \$3.45. On the basis of the available comparisons, we believe that the price elasticity of demand within the US may be about 0.47, although within our pricing model we have used a more conservative 0.36.

In conclusion, I would simply stress those aspects of the Proposed Resolution that I believe should receive fuller consideration:

1. That non-financial measures may have a greater impact on reducing teen smoking and national smoking incidence than price increases alone;
1. Potential bankruptcy of the weaker US manufacturers could result from some of the legislative proposals currently under consideration. If this occurred, it may dilute the ability of the industry's opponents to regulate US tobacco manufacturing, and to realize damages from bankruptcy-protected defendants;
1. The potential bankruptcy of any US manufacturer would likely hurt tobacco farmers and all domestic economic beneficiaries of the industry. This would achieve none of the public health goals espoused by the settling states and may result in a benefit to some foreign manufacturers.

Finally, and by way of observation, I believe that at current valuation levels, the equity markets have largely concluded that Congress and the Administration will fail to seize the opportunity to legislate comprehensive tobacco legislation during 1998.

Thank you for your listening. I am willing to assist the Commerce Committee in any way that I am able.

- _____